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REFORM WITH UK OFFICIALS (CORRECTED COPY - SPACING)

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¶1. (SBU) Summary. Bonuses, regulatory structures, and EU legislation led the discussions of Senators Richard Shelby (R-Ala) and John Cornyn (R-Texas), and Representatives Paul Kanjorski (D) PA), Scott Garrett (R) NJ) and Luis Gutierrez (D) Ill) during their recent meetings in London. During the September 2-7 visit, the two Congressional delegations jointly met with Members of Parliament from the Treasury Select Committee; with Lord Adair Turner and his staff from the Financial Services Authority, and with leading banking executives. A constant theme was the need for regulatory convergence and for changes to occur methodically, not hastily. End Summary.

MPS: Bonuses and Brussels Top Concerns

¶2. (SBU) Members of Parliament from both the Labour and Conservative Parties cited the "group think" of bankers and lack of oversight from boards of directors as one of the root causes of the economic crisis. John McFall, Committee Chairman and Labour MP, criticized the board of directors of Royal Bank of Scotland for not questioning RBS's purchase of ABN Ambro at the height of the market and without doing due diligence of the Bank. Michael Fallon, Conservative MP, highlighted the failure of corporate governance and ineffective self-regulation by the industry.

¶3. (SBU) In response to Senator Shelby's query about how we move beyond the crisis and fix the problems, McFall suggested that bank salaries and bonuses had to be a top priority. He said, however, that the Financial Services Authority's proposed guidelines on remuneration are weak, and what already is being seen, with the latest news about bonuses being paid out, is that "the punch bowl has moved to the center of the table, with a bigger ladle." He was disquieted by the "business as usual" mentality that seems to be emerging once again in the banking industry.

¶4. (SBU) The MPs expressed concern about actions in Brussels. Fallon said the draft EU Alternative Investment Fund Managers directive was protectionist and would erect a wall around Europe and disadvantage non-European investors. The UK should strongly oppose this directive, since it would weaken London as a global financial center. The French, he said, were taking the hardest line on the AIFM, though curiously he noted that France has no real hedge fund industry. He surmised that the French were taking such a hard line to be able to do some horse-trading later, and get UK acquiescence on issues that matter to them, like bonuses and compensation. Mark Todd, Labour MP, commented that Brussels saw the crisis as an opportunity to challenge the Anglo-Saxon model of markets. Andrew Love, Labour MP, noted that there was a great communality of interests between the

UK and the U.S., and that our two governments need to work together more effectively in influencing Brussels) a comment echoed by all the other MPs. Todd and Sally Keeble, Labour MP, noted the need to have international coordination especially when dealing with large, systemically important firms. Though, she wryly mused, that if there had been an international effort to save Lehman Brothers, the French would have gotten involved only if they received the "glory," and the Germans only if they could get jobs out the rescue plan. All MPs expressed concern that the UK's financial services interests could be undermined by actions in Brussels.

¶5. (SBU) Fallon also noted the international debate has centered on the questions of systemic risk and financial stability, but both terms, in his view, have not been adequately defined. Without a proper understanding of what real objectives were meant to be reached under this rubric, any regulatory structure created would be inadequate.

FSA: More Capital, Better Boards

¶6. (SBU) Lord Adair Turner, Chair of the Financial Services Authority (FSA), identified several causes to the crisis: too much leverage, insufficient liquidity, too low reserves, too much focus on mark-to-market accounting rules, too much risk-taking, too little oversight by boards of directors. A multi-tiered approach was needed to prevent such crises in the future, he said. Among the steps required: higher capital reserves, including, perhaps, a capital surcharge on the biggest banks) the systemically important firms; greater oversight by boards and shareholders of pay and bonuses; greater accountability of boards; and "living wills" for systemically important firms.

¶7. (SBU) Specifically, he argued, banks needed a large buffer

of equity capital, and that capital requirements should increase in step with the risk involved with their activity. He stated that regulators were still struggling with the concept of what was "too big to fail") and why financial services firms did not, or could not, fail as other major corporations did by following such procedures as declaring bankruptcy and going to court to deal with holders of credit and of debt. He supported "living wills" for failing firms, but cautioned about the practicality of such wills, since business activity was not stagnant and wills would be outdated the minute they were completed. Nevertheless, wills would force an examination of complex corporate structures that could enable authorities to better understand the institutions they regulate. He also thought such wills could improve corporate governance by increasing transparency. On pay, he agreed with Representative Garrett's (R-NJ) observation that the issue was turning into a "red herring." Bonuses, he said, had not been at the heart of the crisis, but the political pressure was mounting to place limits on bonuses. Regulators, he said, should not mandate levels of pay, but they could address the structure of how people were paid; whether, for example, there were immediate cash payments or payments deferred until profits/losses were cleared from the books. The issue should be the nature of incentives; employees should not be rewarded for "bad behavior." He said he supported a "claw back" provision on bonuses should activity later come to light that would be deemed as too risky. He stressed that boards of directors and shareholders need to take on greater oversight of pay.

¶8. (SBU) Negligent boards of directors bore much of the responsibility for the crisis, he argued, failing to provide oversight or check risky activity. As a direct result of the crisis, the FSA has ramped up its review of the composition and qualifications of directors and was interviewing, in many cases, non-executive members of boards, and turning them down if they did not have the appropriate competency levels. In its oversight of financial services, the FSA will ask boards

whether they are looking at the whole range of business activity and what guidance they are providing on pay.

¶9. (SBU) Hedge funds also were at risk of becoming a populist issue, Turner noted. He said that hedge fund activity was not a cause of the crisis, and most funds were significantly less leveraged that many banks) on average two to one for hedge funds versus twenty to one for investment banks. But in continental Europe, hedge fund managers were being perceived as the villains. He argued that regulators should have the absolute right to gather information about funds to review their systemic risk. And if there were concerns, regulators could impose greater capital requirements, but he did not believe that a regulation of the industry itself was necessary.

¶10. (SBU), Turner said institutional architectures were the least important issue. The key issue was not structure, but philosophy) that market forces would guarantee stability. He argued that changing the overall regulatory architecture in the UK was not necessary, but increasing the competency of and funding for regulators were essential. When asked about the "Tobin tax" (tax on all trade of currency across borders), Turner said the idea has generated much comment and criticism, but said such a tax was impractical and could not be implemented.

Bankers Speak Out: "Help Us Help Ourselves"

¶11. (SBU) A single systemic risk regulator was needed, the bankers unanimously agreed. The banking industry can not regulate itself sufficiently to prevent any future crisis. The regulator must be able to check the industry's worst impulses, said Gary Lynch, Executive Vice President and Chief Legal Officer, Morgan Stanley, at an Embassy-hosted roundtable.

¶12. (SBU) In the U.S., the bankers agreed it should be the Federal Reserve Board, which already has authority for price stability and economic growth. Adding authority for financial stability would enable the Fed to monitor systemic risk. In the UK, they were mixed about whether the Bank of England should be granted greater authority, or whether the current tripartite structure) with the BOE, Treasury and Financial Services Authority having different oversight obligations) should remain intact. Stephen Green, Chairman HSBC, argued that under the current system in the UK, the public armor lacks "weapons." The BOE has been traditionally focused on inflation; neither the Bank nor the FSA was watching the flow of money in and out of the financial

system. They were not concerned with capital reserves or liquidity. He argued that there needed to be a single regulator in the UK and that it must have a broad oversight mandate. The BOE, he said, should be able to control the flow of credit, manage capital ratios) and have responsibility over all systemically important firms.

¶13. (SBU) Regarding pay and bonuses, the bankers all agreed that bonuses structures should be reviewed, and that pay and performance should be closely linked. They cautioned however about letting political pressures dictate such structures or any reform efforts. Angela Knight, President of the British Bankers' Association, argued that the industry was facing political risk; that political leaders were responding to public anger but were not addressing real issues. Some continental European leaders, she said, dislike hedge fund managers and their personal wealth, and see this crisis as an opportunity to get a grip on greed. This was part of the motivation behind a seriously flawed draft EU directive on hedge funds. She commented that the incoming European Commission would want to be seen as tougher on bankers than the outgoing Commission.

¶14. (SBU) On prospects for global economic recovery, the bankers also offered mixed views. UK exports were up and unemployment continued to rise but at a slower rate. Glenn Earle, Chief Operating Officer, Goldman Sachs, cited an increase in corporate bond issuances and a reduction in corporate debt, especially in terms of short-term debt. These were signs that the economies are healing, but the long-term prognosis was still uncertain, he said. He said that rising unemployment and savings rates would repress consumption; for how long was unclear. J. Eric Daniels, Chief Executive, Lloyds Banking Group, stated that consumer confidence was up in the UK, and noted that lower interest rates had reduced mortgage payments (by an average GBP 200 pounds per month) and raised consumers, disposable income. He also observed that inventories were being re-stocked and some delayed capital purchases were now being made. But he pessimistically noted that he did not see a real engine for growth in the UK or the U.S. It was a debt-fueled boom before, and without real gains in productivity, he said he did not expect a return to real growth anytime soon.

¶15. (SBU) Global imbalances) between saving and borrowing cultures) also still need to be addressed, argued Sir Win Bischoff, who takes over as Chairman of Lloyds Banking Group later this month. He noted that Asian growth remained dependent on the U.S. market. Green observed that Asia was rescuing global growth once again, with both China and India expected to have growth rates of eight percent or higher in the next 12 months. Agreeing with Bischoff, he said there was a real risk for Asia if the U.S. did not really start to recover until end of 2010. Growth in China was being driven by greater domestic spending on infrastructure, timetables for which were moved forward to pump money into the economy. These projects will be completed by summer 2010. The question, he asked, was what will take its place as a driver of growth?

RBS: Mistakes Were Made

¶16. (SBU) In a separate meeting with Representatives Kanjorski, Garrett and Gutierrez, Royal Bank of Scotland Chairman Sir Philip Hampton (who was appointed by the UK government in April) acknowledged that RBS had made several enormous mistakes. Top among them was its heavy exposure in the U.S. subprime market and the bank's purchase of ABN Ambro, which occurred at the height of the market and without RBS doing proper due diligence prior to the purchase. The board of directors never questioned this purchase, which Hampton termed a failure of their fiduciary responsibilities.

¶17. (SBU) Hampton spoke about RBS's de-leveraging. It has set up a non-core bank with GBP 250 billion in capital to absorb its toxic and non-performing assets; it has a three-year plan to get all its toxic assets off its balance books. It will also eliminate less profitable business activity, such as marine and aviation lending) in which RBS had been the global leader. It will retain the U.S.-based Citizens Bank, but will likely reduce the number of branches. (As an aside, Hampton noted that RBS is the number one broker/dealer of U.S. Treasuries, and that the USG should be interested in RBS's health, given the anticipated increase in sales of U.S. Treasuries.) RBS has raised GBP 50 billion in capital in the past 12 months, though two-thirds of that was from the government. He expected the government would retain its stake in RBS for several years and would only begin to reduce

its holdings once the market recovery is certain. He predicted the government would sell RBS off in several tranches over the next three-to-five years.

¶18. (SBU) On industry-wide issues, Hampton supported some regulatory oversight of pay and bonuses but said he preferred a light touch) otherwise, the most talented people might leave and go to non-regulated industries. He argued that

there needed to be one global accounting standard; the lack of uniformity played to the advantage of those who knew how to exploit the differences. He also supported higher capital reserves requirements, even among mid-sized banks. One lesson to be learned from the crisis is that regional players can become global players, like RBS did, in a matter of years, and regulators need to anticipate this potentiality.

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